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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, JUNE 4-12, 2007

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period June 4-12, 2007. The unclassified email version of this report includes tables and

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charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- Argentina's trade deficit with Brazil narrows 15% due to strong Real
-- Exports rising, imports increasing faster, but terms of trade improving
-- U.S. closes antidumping case against Argentina
-- Energy shortages impact growth projections for 2007
-- Are Argentina's reserves and resulting costs of sterilization too high?
-- GoA issues peso denominated Bonar V at a yield of 11.70%

Economic Outlook

Argentina's trade deficit with Brazil narrows 15% due to

strong Real
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¶2. (U) Argentina's trade deficit with Brazil shrank over the first five months of 2007, the first such reversal in several years. Exports to Brazil in that period were $3.9 billion, 35% more than the same period in 2006, led by a 68% increase in exports of autos and auto parts. Imports were $5.1 billion, 18% higher. The resulting trade deficit of $1.27 billion was 15% lower than the deficit for the same period in 2006 ($1.5 billion). Local analysts attribute the change to the stronger Real. Argentina had a $2.3 billion surplus with Brazil in 2002, followed by deficits of $33 million in 2003, $2.1 billion in 2004, and $4.1 billion in both 2005 and 2006. Imports from Brazil grew from $2.5 billion to $12.3 billion during that period, while exports only rose from $4.8 to $8.1 billion.

Exports rising, imports increasing faster, but terms of trade improving
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¶3. (U) Exports in dollars rose 9% y-o-y in April, to a record monthly high of $4.261 billion. This increase was due to an 8% y-o-y increase in prices and a 1% y-o-y increase in quantities, and primarily explained by exports of cereals. Imports rose 23% y-o-y in April to $3.139 billion, mainly due to increased quantities (22%). Imports of intermediate goods and parts of capital goods, accounted for 66% of this increase. April's trade surplus was $1.162 billion, or 18% lower than in April 2006. Exports rose 10% y-o-y in the first four months, to $15.27 billion, while imports increased 24% y-o-y to $12.3 billion. The surplus was $2.97 billion during the first four months, or 23.8% y-o-y lower than the equivalent period in 2006.

¶4. (U) Argentina has benefited from the commodity price boom, but not to the same degree as many other commodity exporting

countries. Argentina is a world-class exporter of agricultural products, but is not as significant of an exporter of petroleum and energy. Petroleum prices in dollars increased 391.5% between 1998 and 2006, while prices for most agricultural goods have only increased between 20 and 30% from their highs in the 1990s. Petroleum prices declined 16.8% between Q3 2006 and Q1 2007, while food prices increased 6% during the same six months. During that period, Argentina's terms of trade (price of exports over price of imports) improved 0.9%, compared to an improvement of 13.9% since Q1 2005.

¶5. (U) Between 2003 and 2006, Argentine exports grew 80% in dollar terms from $25.65 billion to $46.18 billion, while imports increased about 280% from $9 billion to $34.19 (Note: imports plummeted by 55.7% in 2002). Argentina still manages to have a trade surplus, partly due to the more favorable terms of trade (but also because of increasing volumes, particularly in agriculture). Although food prices have not grown as much as those of petroleum, the former exhibit a growing trend that appears likely to continue in the medium term, which bodes well for Argentina's ability to maintain its trade surplus.

U.S. closes antidumping case against Argentina
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¶6. (SBU) A bilateral trade dispute between the U.S. and Argentina, dating to 1995, appears to be finally nearing the end. The U.S. has applied antidumping duties to Argentina's exports to the U.S. of oil country tubular goods (OCTG - specialized steel pipes used in petroleum fields) since 1995, and the Argentine government filed WTO complaints against the U.S. for its sunset reviews in both 2000 and 2005. The appeal was finalized on April 12, 2007, with both sides claiming victory, as U.S. sunset procedures were upheld but the duties in this specific case were unsupported.

¶7. (SBU) Accordingly, the U.S. announced May 31 that it would revoke the antidumping duties. However, on May 25 the GoA had stated its intention to seek $44 million in compensation for lost exports. Although an Econ Ministry contact says the

GoA claim "should be dropped" if the duties have been revoked, a Foreign Ministry official familiar with the case said that the U.S. announcement to revoke duties was "an excellent signal," but the GoA would wait for the official revocation before terminating its compensation request.

Energy

Energy shortages impact growth projections for 2007
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¶8. (U) Dr. Daniel Artana, the Chief Economist of FIEL (Fundacion de Investigaciones Economicas Latinoamericanas), one of Argentina's most well-known private think-tanks, stated during a May 30 presentation that recent gas and power cuts would adversely impact Argentina's economic growth in ¶2007. He blamed the cuts on the unusually cold weather in May, but they are also the expected result of the GoA's policies since 2002 of controlling utility prices. These tariff controls have deterred new investment in exploration (for gas), as well as in generation, transmission, and distribution of both electricity and gas. Using as a reference Brazil's experience and energy rationalization plans enforced at the end of the 1990s, Artana estimated that

energy sector problems would result in a reduction in 2007 real GDP growth of up to one percentage point. However, he argued that the impact of energy problems in Argentina could be even worse than they were in Brazil, since the GoA has enforced rationing on industries and commercial users while protecting residential users as much as possible. Conversely in Brazil, Artana stated, all sectors shared the brunt of the shortages.

Banking and Finance

Are Argentina's reserves and resulting costs of sterilization too high?

¶9. (U) During the May 30 presentation, FIEL Chief Economist Daniel Artana compared the amount of Argentina's official reserves against those of Brazil and Mexico. He used different measurements to assess whether Argentina had amassed an excessive amount of reserves as a result of its policy of purchasing foreign currency to avoid the nominal appreciation of the peso. Artana noted that Argentina's reserves/GDP ratio of 18.5% was high relative to Brazil (12.1%) and Mexico (7.1%). Argentina also has 14.4 months of import cover, significantly higher than Mexico's 3.3 months, although only slightly higher than Brazil's level. Artana also compared several reserve/debt ratios (including both public and sector debt), which in most cases show Argentina as having a margin -- compared to the other two -- to continue accumulating reserves.

¶10. (U) The flip-side of the Central Bank's reserve accumulation policy is the cost of sterilizing the increased money supply, which it does by issuing relatively short term bills and notes (Lebacs and Nobacs). According to Artana, the BCRA still has a margin to continue issuing debt without incurring a quasi-fiscal deficit (difference between the interest earned and paid on BCRA assets and liabilities). However, he argued that this window would close relatively soon. He commented that Central Bank President Martin Redrado would not want to be remembered as the one responsible for running a quasi-deficit, so would soon pursue alternative ways to mop up (or absorb) excess peso liquidity (Note: Artana assumes that allowing the peso to appreciate is not an option). One option would be to increase bank reserve requirements, which he has already done once in 2007. A better option would be for the Economic Ministry to use its own peso reserves from the primary fiscal surplus, which do not need to be sterilized, to purchase foreign currency. However, most analysts consider this unlikely prior to the October Presidential elections.

GoA issues peso denominated Bonar V at a yield of 11.70%
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¶11. (U) On June 7, the GoA successfully issued ARP 1.5 billion (approx. $500 million) of the Bonar V (or Bonar 2012), a peso denominated, five-year bond, with a fixed coupon rate of 10.50%, at a yield of 11.70%. This was the first time since the 1990s that the GoA issued a fixed-rate, peso denominated bond without an adjustment for inflation clause. (Note: The GoA last issued a peso denominated bond in July 2005, the Boden 2014, but this bond was adjusted by CER - a CPI-linked index. The GoA also issued peso-denominated bonds as part of the mid-2005 debt exchange, but these were also indexed to inflation).

¶12. (U) The 11.7% yield split the middle of the market's expected range of 11.25-12.20%. However, traders praised the result of the auction, given the negative market environment last week generated by expectations of FED rate increases and also following continued, high-profile GoA manipulation of official inflation statistics (Note: The statistical agency, INDEC, published a 0.4% inflation rate for May, lower than even the most optimistic private sector estimates).

¶13. (U) The auction was more than three times over-subscribed, with total bids of ARP 5.2 billion. Local and international analysts tell Post that foreign investors searching for high yields and minimal currency risk purchased the vast majority (over two-thirds) of the issuance. JP Morgan Chase, Deutsche bank, and Citibank together purchased over 50%. In addition to the high yield, the ability to use the bond to get around capital controls may partly explain the popularity of the bond (Note: primary issuances are exempt from the BCRA requirements of a one-year minimum investment, with a 30% unremunerated deposit).

¶14. (U) GoA Finance Secretary Sergio Chodos stated publicly that the goal of the issue was not only to raise funds, but also to build out a peso-yield curve (which would be used as a reference for the private sector). With this transaction, the GoA would only need to raise about $2.6 billion more to meet its budgeted 2007 financial needs of $5.7 billion. However, a local think tank (Melconian) argues that the GoA's increasing expenditures so far during this election year will require it to raise an additional $2 billion on top of the $5.7 billion amount. Given the relative success of the auction, analysts expect the GoA to tap the market again in the near future (also confirmed by GoA contacts). The GoA also has up to $1.0 billion more of the dollar-denominated Bonar X (10-year, fixed rate) available for issuance. However, most analysts expect the GoA to hold off with further issuances of dollar bonds, since they have suffered in recent weeks as a result of rising Treasury rates (Note: the Bonar X was issued with a yield of 8.44% on May 10, but it is now trading at 9.20%.)

¶15. (SBU) To secure the success of the issue, the GoA apparently attempted to limit competition in the week leading up to the auction. The CNV (GoA securities regulator) reportedly tried to block new issues from the private sector (specifically from the banking and energy sector) to reduce the upward pressure on the peso (from incoming dollar flows) and also to keep the market clear for a GoA peso denominated issue. However, Post's private sector contacts assert that the GoA quickly backed off and allowed the issuances to go through. Interestingly, the private sector has been able to issue peso (and dollar) debt at lower yields than the sovereign in recent months. Two recent examples are Banco Macro's early June issuance of a 5-year, peso linked (pays in dollars but at spot exchange rate) corporate bond for the equivalent of $100 million at a yield of 10.75%, and Banco Santander-Rio's issuance in April of a ARP 450 million 3-year bond at a yield of 11.375%.

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